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# ASB meeting minutes, 2002, December 17-19; Auditing Standards Board approved highlights, 2002, December 17-19, meeting

American Institute of Certified Public Accountants. Auditing Standards Board

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**AUDITING STANDARDS BOARD**  
**Approved Highlights**  
**December 17-19, 2002 Meeting**  
**Las Vegas, NV**

**Meeting Attendance**

James Gerson, Chair  
Jeffery Bryan  
Craig Crawford  
Lynford Graham  
Auston Johnson  
Kenneth Macias  
Susan Menelaides  
William Messier  
Alan Paulus  
Stephen Schenbeck  
Michael Umscheid  
Bruce Webb  
Carl Williams

Members Absent

John Fogarty (via conf. call)

AICPA Staff

Chuck Landes, Director, Audit and Attest Standards  
Susan Jones, Senior Technical Manager, Audit and Attest Standards  
Julie Anne Dille, Technical Manager, Audit and Attest Standards  
Gretchen Fischbach, Technical Manager, Audit and Attest Standards  
Kim Gibson, Technical Manager, Audit and Attest Standards

Observers and Other Participants

John Brolly, PricewaterhouseCoopers, LLP  
Robert Dohrer, McGladrey & Pullen, LLP  
Howard Meltzer, KPMG, LLP  
David Noonan, Ernst & Young, LLP  
Esmeralda Rodriguez, Securities and Exchange Commission  
Tania Sergott, Deloitte & Touche, LLP  
Garrett Stauffer, Chair, Internal Control Reporting  
Eric Turner, Canadian Institute of Chartered Accountants  
Mary Ann White, Practitioner's Publishing Company

## II. CHAIR AND STAFF REPORTS

Jim Gerson and Chuck Landes provided updates on the recent Audit Issues Task Force meeting and other matters.

## III. AGENDA ITEMS PRESENTED AT MEETING

### **Omnibus**

Susan Menelaides presented a document listing sections of the Sarbanes-Oxley Act of 2002 and describing the effect that each section would have on the proposed omnibus standard. The Board agreed with the way that the task force proposed to incorporate the aspects of the Act into the standards. Ms. Menelaides then presented the proposed content of the omnibus standard. The Board reviewed and commented on the documents. The task force agreed to consider the Board's comments, and bring a revised draft to the ASB in February, with a plan to vote it out for exposure at that time. The Board agreed to expose the three Sarbanes-Oxley related standards (Audit Committees, Reporting on Internal Control, and the Omnibus) simultaneously.

### **Internal Control Reporting**

Garrett L. Stauffer, Chair, Internal Control Reporting Task Force (task force), led a discussion about tentative conclusions and open issues related to guidance that the task force is developing on engagements to report on the effectiveness of internal control in conjunction with the financial statement audit as mandated by the Sarbanes-Oxley Act of 2002 (the Act). The task force is drafting:

- A proposed Statement on Auditing Standards (SAS) specifically to address these engagements
- Amendments to SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*
- Amendments to Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*, AT section 501, "Reporting on an Entity's Internal Control over Financial Reporting" (AT section 501).

The task force also will draft other conforming amendments to the auditing literature as necessary.

Mr. Stauffer presented the following project timeline with which the ASB concurred:

- Vote documents for exposure at the February 11-13 ASB meeting
- Expose documents on March 1 with a 60 day comment deadline (April 30)
- Present an analysis of comments and initial revisions to documents at the June 3-5 ASB meeting

- Vote documents for issuance at July 29-31 ASB meeting

Mr. Stauffer stated that the task force is drafting the guidance to be consistent with recommendations in the AICPA comment letter on the Security and Exchange Commission's (SEC's) proposed rule on Section 404 of the Act. Given the need to issue guidance timely, and the uncertainty about whether a final SEC rule will be available later in January, the ASB concurred with this approach. The task force expects to communicate with SEC staff and with the Public Company Accounting Oversight Board (PCAOB) concerning the proposed guidance before exposure, to the extent feasible, and also during the exposure period. In addition, the task force intends to elicit the views of constituents such as the Financial Executives Institute prior to and during the exposure period.

The following are among the more significant matters with which the ASB concurred:

- The proposed new SAS will apply only to engagements subject to the Act (including public entities also subject to the Federal Deposit Insurance Corporation Improvement Act) because of the Act's unique reporting and communication requirements; however, auditors of other entities may look to the SAS for guidance on such matters as the relationship between the audits of the financial statements and of internal control when both are performed concurrently, and for sample language on a combined report on the financial statements and on internal control.
- AT section 501 will remain the "core" guidance on engagements on internal control over financial reporting, and thus the proposed new SAS will refer auditors to that standard for guidance on such matters as conditions for engagement performance, performance guidance, and "basic" reporting guidance.
- AT section 501 will be amended to enhance the performance guidance applicable to all engagements to examine the effectiveness of internal control over financial reporting in order to achieve greater consistency in practice.
- SAS No. 60 will apply to all audits except those subject to the proposed new SAS.
- SAS No. 60 will be amended to replace the terminology "significant deficiencies" for "reportable conditions."
- When the auditor is performing an examination of internal control in conjunction with an audit of the financial statements under the proposed new SAS it is appropriate to refer to both as "audits."
- The evaluation of internal control does not extend to the internal control of entities in which the reporting entity has an investment that is accounted for by the equity method of accounting.

ASB recommendations to the task force included the following:

#### *General*

- Further develop the guidance defining a third "level" of control deficiencies (alternatively, control deviations or control exceptions) that the auditor may detect during the audit;

however, a threshold needs to be established to exclude “de minimus” exceptions from consideration. In addition, consider the auditor’s responsibility to communicate such deficiencies (whether optional or required, and to whom) in various circumstances.

- Acknowledge in the performance and reporting guidance that is being developed that override of internal control by management constitutes part of the inherent limitation of internal control.
- Amend SAS No. 100, *Interim Financial Information*, to strengthen the guidance on updating the understanding of internal control as it relates to identifying significant changes to internal control, evaluating the design effectiveness of such changes, considering whether they may result in significant deficiencies, and communicating to management.

#### *Proposed new SAS*

- Focus the guidance in paragraph 9 on the extent of tests of controls sufficient for an audit of internal control, compared to the extent of tests of controls sufficient for an audit of the financial statements, on the scope or range of controls to be subjected to testing rather than on the number of times a given test is performed.
- Expand the guidance in paragraph 9 on the sufficiency of testing to address nature (including perhaps distinguishing between testing preventive vs. detective controls) and timing, as well as extent, and indicate that the combination performed should provide the auditor with sufficient assurance to opine on internal control.
- Edit the combined report in the Appendix to improve the flow of the language and to conform to language from the “stand-alone” report that is missing in the combined report.
- Consider whether the engagement should be subject to review by another partner.

#### *AT Section 501 Amendment*

- Emphasize the guidance in paragraph 4 that the auditor cannot perform the engagement, or give an unqualified opinion, in the absence of sufficient evidence to support the responsible party’s evaluation.
- Consider how to clarify the guidance in the proposed changes to paragraph 9 on management’s thresholds for capturing material weaknesses and significant deficiencies.
- Clarify the meaning in paragraph 18b that the thresholds established by the auditor to evaluate management’s process would be “at levels less than those normally associated with the concept of financial statement materiality.” Is financial statement materiality, essentially a quantitative concept, necessarily applicable to the evaluation of the effectiveness of internal control? Put another way, if a control is deficient, isn’t it still deficient even if it has no financial statement consequences? Consider the use of examples to clarify how materiality might be applied by the auditor. Also, investigate whether the firms have guidance on this with respect to FDICIA engagements on internal control.
- Clarify the guidance on materiality by discussing various matters the auditor should consider in making a determination about what is or is not material, rather than trying to establish direct links between material financial statement accounts and specific controls.

- Discuss with the Audit Issues Task Force (AITF) the status of the International Auditing and Assurance Standards Board (IAASB) project on audits of entities operating in multiple locations to determine how the guidance in paragraph 19 may be affected.
- Embellish the guidance in paragraph 20a on using the work of internal auditors to clarify that the auditor cannot rely solely on the testing of internal auditors when such testing is the basis for management’s conclusion about the effectiveness of internal control.
- Increase the specificity and robustness of the guidance in paragraph 29 about the sufficiency of evidence obtained.
- Develop more fully the concept introduced at paragraphs 35b – 39 of “aggregating” control deficiencies, considering that there may be situations where deficiencies cannot be aggregated, and situations where a compensating control may mitigate the effect of a control deficiency.

#### *SAS No. 60 Amendment*

- Restore paragraph 6.
- Restore the guidance in paragraph 9 that permits the auditor to communicate orally.
- Amend paragraph 15 to require the auditor to separately identify and communicate those significant deficiencies that the auditor considers to be material weaknesses.
- Consider deleting paragraph 17.
- Obtain input from the AICPA’s Technical Issues Committee on the above proposed changes.

#### **Fair Value**

Susan Menelaides, Chair of the ASB Fair Values Task Force led the discussion of the proposed Statement on Auditing Standard (SAS) that will provide guidance to auditors for auditing fair value measurements and disclosures. The proposed SAS, entitled *Auditing Fair Value Measurements and Disclosures*, is based on a proposed International Standard on Auditing (ISA) by the same name.

S. Menelaides informed the ASB that the Task Force had considered 14 comment letters and proposed revisions to the draft SAS in response to those comment letters. The most significant types of changes that the task force proposed to the ASB related to changes to:

1. More closely reflect the fair values “hierarchy” that is in the more recent Financial Accounting Standards Board Statements.
2. Clarify the guidance for corroborating fair value estimates with subsequent events that appeared in paragraphs 42, 43, and 48 of the exposure draft.
3. Conform, to the extent possible, the guidance in the proposed SAS to the guidance in the fair values ISA that was issued in the Fall of 2002.

After discussion, the ASB voted unanimously to issue as final the SAS entitled, *Auditing Fair Value Measurements and Disclosures*.

### **Audit Committee**

Mr. Bruce Webb discussed with the ASB the proposed revisions to existing professional standards containing guidance on audit committee communications to reflect the applicable provisions of the Sarbanes-Oxley Act and the SEC's proposed rule, *Strengthening the Commission's Requirements Regarding Auditor Independence*.

The following proposed revisions to professional standards were discussed:

#### **Amendment to SAS No. 1, *Codification of Auditing Standards and Procedures*, AU Section 310, *Appointment of the Independent Auditor*.**

- Inclusion of the audit committee's responsibilities as discussed in the Sarbanes-Oxley Act, including appointment, compensation, and oversight of the work of the auditor and that the auditor is to report directly to the audit committee.
- Proposed revision to require written communication between the auditor and the client (often referred to as an engagement letter).
- Addition of items to be included in the understanding, such as required communications to the audit committee, and management's responsibilities regarding the design and implementation of programs and controls to prevent and detect fraud, and for informing the auditor about all known or suspected fraud affecting the entity involving (a) management, (b) employees who have significant roles in internal control, and (c) others where the fraud could have a material effect on the financial statements.

#### **Amendment to SAS No. 61, *Communication with Audit Committees*, AU Section 380.**

- Inclusion of a revised definition of audit committee based on the Sarbanes-Oxley Act. The proposed definition is as follows (footnotes omitted):

*An audit committee is (a) a committee (or equivalent body, such as a finance committee or a budget committee) established by and amongst the board of directors or other governing body for the purpose of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity; or (b) for Securities and Exchange Commission (SEC)<sup>1</sup> engagements, if no such committee exists, the entire board of directors. In some SEC engagements, the entity may not have either an audit committee or a board of directors (e.g. a limited partnership). In such cases, the auditor should consider the individual general partner(s), the audit committee or board of directors of the corporate general partner, or others with equivalent responsibility as fulfilling the role of the audit committee.*

- Required timing of communications for SEC engagements.
- Required communications/reporting for SEC engagements which include:
  - a. report to the audit committee all of the entity's critical accounting policies and practices applied in its financial statements,
  - b. report to the audit committee all alternative treatments of financial information within generally accepted accounting principles, including significant recognition, measurement, presentation and disclosure alternatives, that have been discussed with management during the current audit period, the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor, and
  - c. discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting policies as applied in its financial reporting.
- Proposed descriptions/definitions of critical accounting policies and practices, and alternative treatments.
- Proposed requirement that the auditor ensure that the audit committee receives copies of all material written communications between the auditor and management.

**Amendment to SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, AU Section 316**

- A proposed amendment to require that auditor to inquire as to complaints received or concerns expressed under the procedures established by the audit committee as a result of the requirement in Section 10A of the Securities and Exchange Act of 1934, which requires each audit committee to establish procedures for: (a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matter; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

A revised document will be discussed at the next ASB meeting which is expected to be voted out as an exposure draft.